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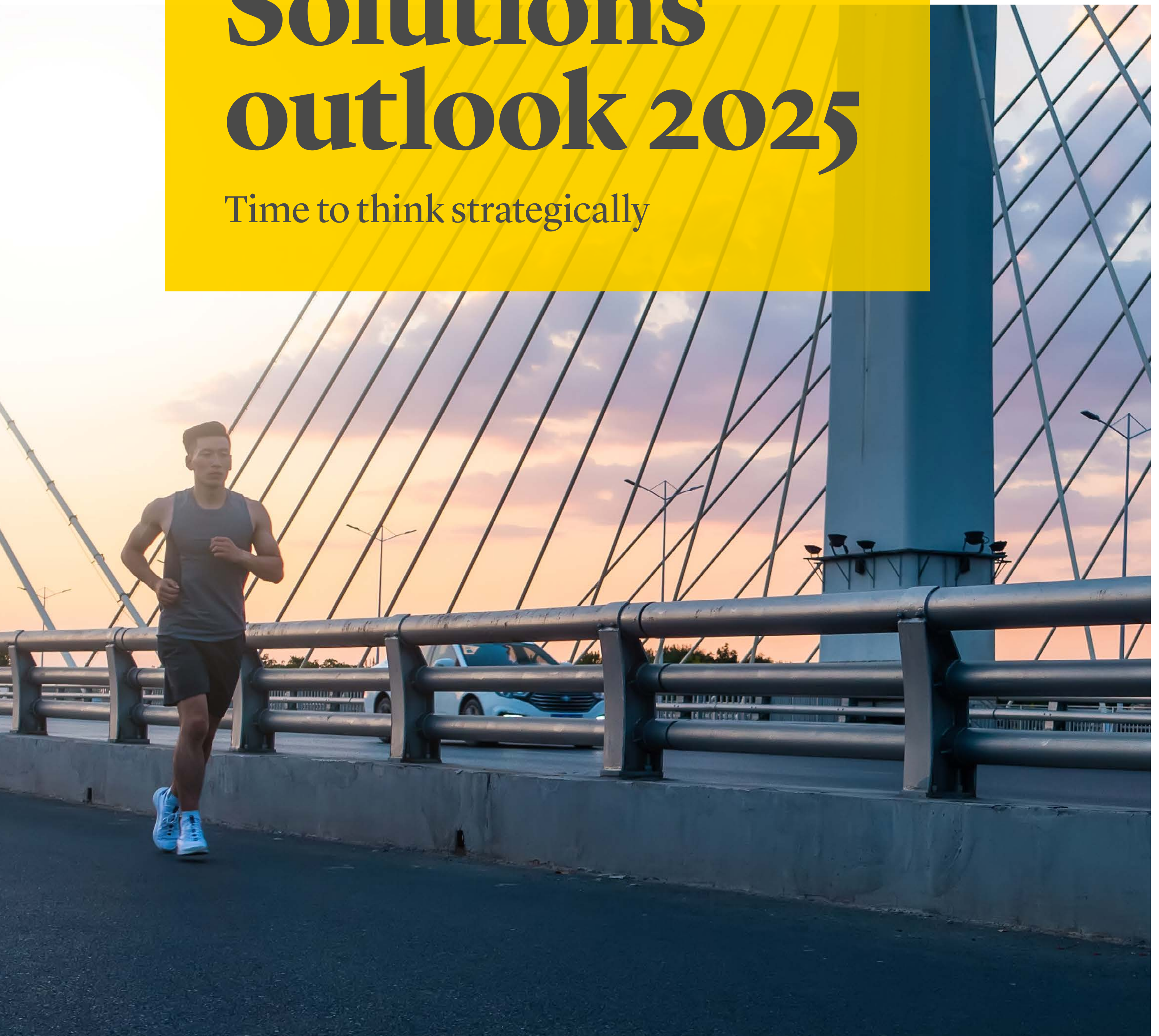
# Solutions outlook 2025

## Time to think strategically



LGIM

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Buyout, run-on or both? We believe DB pension funds have much to be optimistic about as they choose their endgame destination. As long-term investors, schemes can take a strategic approach to surplus generation and asset allocation, while harnessing flexible solutions to manage their private and illiquid asset exposure as they prepare for a buyout transaction.

## Growth is back on the agenda.

In her November mansion house speech, the Chancellor discussed “plans to create Canadian and Australian style- “megafunds” to power growth in our economy”.
In addition to the DC and Local Government Pension Scheme focus, there was a nod to insurers: “The PRA, the Treasury, and the National Wealth Fund will work together to crowd in investment by insurers in productive assets.”

While DB funds were not specifically mentioned at this stage, the merits of thinking strategically around growth are very much front and centre on scheme agendas, with formal feedback around surplus extraction likely to arrive in 2025. Certainly, with DB assets of c.£1.2 trillion and over a third of schemes (by value) being in surplus on a buyout basis, as at 31 March 2024[1], there is much to think about.

Although we await the announcement of the finer details around surplus extraction, for those schemes that are choosing to run on and seeking to extract surplus, we recognise the necessity of mutually agreeable guardrails for both the sponsor and trustees. In this vein, we expect there to be practical workable solutions, which we introduce in **No more natural guard rails?**

Meanwhile, we already have a good idea around a plausible strategy for surplus extraction based on our long-term asset liability modelling and outline this in **Unlocking surplus in the endgame**. We conclude that for schemes with sufficiently high funding levels and thresholds for extraction, security and surplus are both possible.

Moving on to investment markets, schemes are well aware that traditional investment grade spreads are low versus history. But as we describe in **Playing the ‘weighting’ game**, there is much more beneath the surface for schemes to weigh up and our research suggests that even at lower credit spreads, a range of long-term credit investments still have their place in DB portfolios whether they are derisking or looking to generate surplus.

Schemes will need reflect on all of the above factors **strategically as they weigh up their endgame options.**

As schemes look to 2025, we believe that they need not be fearful of illiquid assets if their circumstances or strategy changes, including if a buyout or buy-in is being executed. In Illiquidity innovation, we outlook how private market transitions can build on similar concepts used in public market transitions, while allowing for key differences.

Schemes will need reflect on all of the above factors strategically as they weigh up their endgame options. Trustees will also need to consider carefully what strategic decisions to retain and what to outsource.

On that note, the new DB funding code is now live. For their low dependency investment allocations, schemes now have to demonstrate investment strategies that are sufficiently liquid to meet cashflow requirements and highly resilient to short-term adverse changes in market conditions.

Our observation is that governance structure will be key, and so a delegated approach could be the way to go to seek to meet these regulations and anything else that might await us as we move through 2025.

Source for both statistics: 1. The Purple Book 2024

**Will Riley**
Head of Solutions

**Robert Pace**
Senior Solutions Strategy Manager

# No more natural guard rails?

## Lessons from the new DB funding code

**Tim Dougall**
Head of Delegated Solutions

The flexibilities afforded under the new funding code are important, however, as **what is suitable for one scheme may not be suitable for another**.

Imagine a bowling game with guard rails to help guide the ball down the lane.

When DB pension schemes were early in their lifecycle, the equivalent of these guard rails was time. Schemes had many years to let expected asset returns help them recover from any funding deficits before pensions had to be paid out. Even better, contributions paid in to fund new accruals had the effect of gently steering the funding level back towards 100%. Just like a young bowler who could rely on guard rails to reduce the risk of a bad outcome, pension schemes in their early years were more innately resilient to short-term fluctuations and risks.

### Avoiding going off the rails

However, as pension schemes have matured, the natural guard rails have been removed. With schemes having to pay out an increasing proportion of their assets each year to pay pensions, any short-term fall in funding levels can quickly accelerate. There's no longer the luxury of time for the funding level to recover. Just as a bowler needs to hone their technique and precision to achieve a good outcome without guard rails, we believe pension scheme trustees and sponsors must now adopt a rigorous risk management approach to ensure their schemes remain financially stable.

With its new DB funding code of practice that came into effect in September 2024, the Pensions Regulator made it very clear that the natural guard rails are gone, and it's time for pension schemes to up their game. In our view, the regulator has rightly highlighted the importance of improved risk management for mature schemes, with a focus on ensuring that assets backing liabilities offer high resilience to short-term adverse changes in market conditions and can match cashflows. The new funding code is less prescriptive than many had initially feared, but as a result the regulator has placed a greater governance burden on trustees, asking them to justify that their specific strategy is fit for purpose.

### Bespoke bowling options

The flexibilities afforded under the new funding code are important, however, as what is suitable for one scheme may not be suitable for another. The regulator has focused heavily on the importance of different employer covenants, and while some schemes remain in deficit, others are now in surplus. Many will want to work their surplus assets harder to seek to deliver an increased cushion against adverse events, improve member benefits, or reduce the cost of pension provision for employers. While some schemes are looking to improve portfolio liquidity ahead of a potential buyout, others are targeting run-on, and may be comfortable seeking to harness an illiquidity premium.

For schemes targeting run-on, even temporarily, the regulator's warning around the need for good governance and high-quality risk management appears to have been heard. Employers are increasingly appointing professional trustees to help manage their schemes, who are in turn looking to beef up investment governance arrangements. An increasing number of larger and mid-sized schemes are looking to appoint an OCIO provider or single implementation manager, while take-up of a fiduciary management governance model continues to be popular among smaller schemes.

Whether small or large, we believe mature pension schemes can learn from the experience of life insurers, who are used to managing risk closely relative to cashflow-negative liabilities in their annuity 'run-on' portfolios. While important differences in regulatory regimes remain, with its increased focus on cashflow matching and risk stress testing, the latest DB funding code aligns approaches more closely for pension schemes and insurers.

### Striking the right strategy

There's a lot of information for trustees, sponsors, and consultants to absorb in the new funding code, and for many the devil will be in the detail. But as the next actuarial valuation cycle approaches, we'd encourage trustees to first take a step back and think about their overall governance and strategy, and whether they're ready for the new challenges that managing a mature pension scheme can bring.

Now that DB schemes have matured, those natural early-year guard rails have gone. Just as professional bowlers do when seeking to improve their average score, schemes need a strategy that avoids the gutter balls.

Many schemes that are already or nearly fully funded on a buyout basis **may still wish to run on**. There are several reasons for this.

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# Unlocking surplus in the endgame

## What key trade-offs do schemes need to weigh up as they choose to run on and target benefit uplifts for members?

For many schemes, 2024 was a time of reflection about their long-term objectives. We expect these conversations to increase in 2025 – particularly when schemes enter their valuation cycles – and the new funding code starts to apply.

### Could run on be the answer?

Many schemes that are already or nearly fully funded on a buyout basis may still wish to run on. There are several reasons for this.

For instance, schemes may not be ready to buy out if they have governance hurdles to overcome, data and benefit specifications to collate, or illiquid asset holdings that need reviewing and can't be transferred to an insurer. On the last point, schemes holding illiquids may wish to read our latest thoughts in the final article of this outlook.

However, there's a powerful reason why even those schemes in a position to buy out may not choose to do so in reality. That motivation lies in the notion that persistent surpluses could potentially be harnessed for the benefit of the sponsor, DB members (in the form of increased benefits or better member experience) or even DC members.

So how should these schemes think about their risk tolerance as they seek the key to unlocking surplus successfully?

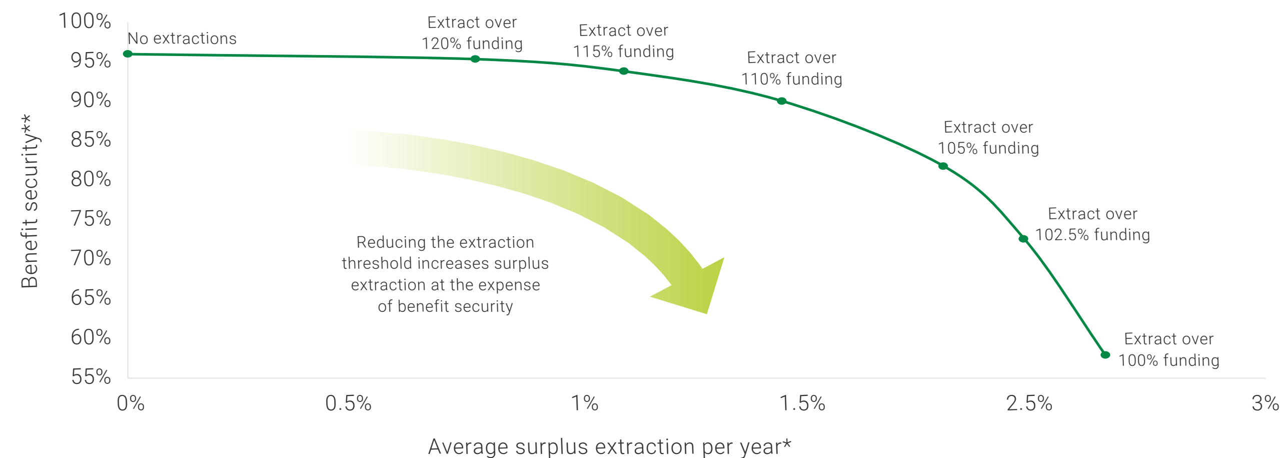
As with strategy design in general, there is no one-size-fits-all solution. In a recent whitepaper, we've looked in detail at how schemes need to weigh up trade-offs when it comes to meeting their objectives. Asset / liability modelling can help schemes achieve this.

### Are security and surplus extraction both possible?

To illustrate, let's consider an example trade-off between the goals of benefit security and the level of regular surplus extraction.

The scheme in this case study invests in a CDI strategy and is initially 110% funded on a suitable basis[2]. Surplus above a certain funding level threshold (as opposed to above a certain amount) is extracted annually. The chart below shows the impact on average surplus extractions and benefit security of varying that threshold. To measure benefit security, we've used the probability that the scheme remains at least 100% funded in 10 years' time.

**The impact on benefit security from surplus extraction is slight if the extraction level is chosen carefully**




* Average proportion of liabilities across scenarios over 10 years. ** Probability of still being at least 100% funded in 10 years.
Source: LGIM calculations, June 2024. For assumptions, please see our whitepaper. **Assumptions, opinions, and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.**

As might be expected, the lower the threshold, the more surplus is extracted on average each year, but the less secure benefits are. If no surplus is extracted the probability that the scheme will still be fully funded (or higher) after 10 years is just over 95%.

Why not 100%? The answer is partially that some investment risk remains. Furthermore, there is the long-term risk that liabilities increase due to members living longer (longevity risk), which is difficult to mitigate in the asset portfolio for all but the largest schemes.

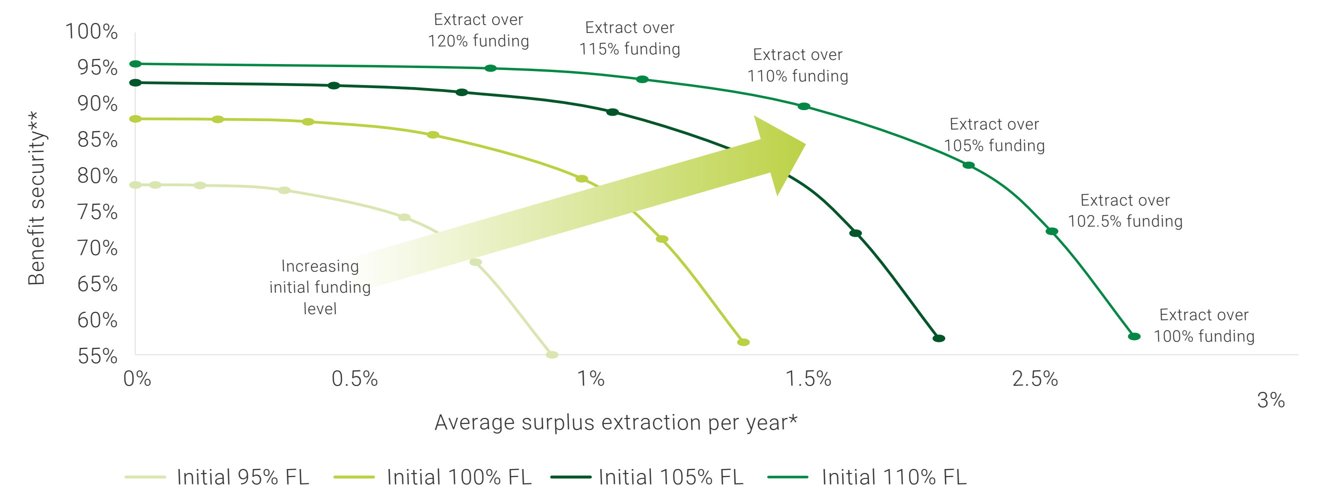
Importantly, the overall trade-off between surplus and security is nonlinear. If the threshold is high, it is possible to extract surplus with minimal impact on benefit security, but the compromise accelerates as the extractions increase. Similar curves can be plotted at different starting funding levels, as shown below:

Here the strength of the employer covenant is important – the above calculations assume no deficit contributions are received in downside scenarios but in reality a strong sponsor is likely to be able to bail out an underfunded scheme.

For many schemes average extractions of 1.5% per annum over 10 years will be extremely attractive – for a scheme with an average asset value of £1bn over the period that £15m could represent a benefit uplift plus distributions to the sponsor.

Designing surplus extraction and investment policies for the new DB landscape is no easy matter. We believe that adopting a holistic approach in combination with scheme-specific analysis can help schemes to understand the trade-offs – including weighing up surplus generation versus long-term security – for their bespoke situation.

**Trade-off curves can be calculated for different initial funding levels**




* Average proportion of liabilities across scenarios over 10 years. ** Probability at least 100% funded in 10 years.
Source: LGIM calculations, June 2024. **Assumptions, opinions, and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.**

2. We have used a dynamic discount basis that varies with credit spreads, but is in line with a gilts basis when spreads are at average levels. This approximates a buyout basis for a mature scheme. The investment strategy could, of course, be higher or lower in risk, which would impact the frontier shown.

**John Southall**
Head of Solutions Research

**Victoria Myers**
Head of Investment Advisory

Our research[5] (which includes theoretical back tests) indicates **it's much more challenging to generate better risk-adjusted returns** than a static strategy by using only a spread signal





# Playing the 'weighting' game

Amid low spreads, some investors have been hesitant to allocate more to credit. But is waiting the right strategy?

As of 30 September 2024, the yield on the iBoxx non-Gilt index traded at c.1.1% above government bonds. This spread is around the 13th percentile. Furthermore, at that point, spreads had been below the 25th percentile for 248 days.

### Insurers' reaction

To manage risk, schemes targeting a buy-in or buyout often consider aligning their hedging to the level of credit-sensitivity within insurer pricing. Insurers are now allocating less to credit for new business, motivating some DB schemes to follow suit.

**Anne-Marie Morris**
Head of DB Solutions Strategy

**John Southall**
Head of Solutions Research

Indeed, our Pension Risk Transfer (PRT) colleagues currently have lower-than-average investment grade credit allocations in their pricing portfolios. However, this doesn't necessarily imply that the credit sensitivity of prices is significantly lower as some credit is replaced by direct investments, which also have some credit sensitivity[3].

Nevertheless, we believe some downward adjustment could be appropriate. While challenging to gauge, we estimate that a scheme that would normally have credit sensitivity (CS01) of 40% to 60% of interest rate sensitivity (PV01)[4] might have only 20% to 40% sensitivity under current market conditions, for example.

## Worth waiting?

Credit has 'time-varying' expected excess returns, with potentially higher expected excess returns when spreads are wider. A potential challenge with timing spreads is that they can remain at tight levels for extended periods, as shown in the table. Investors who wait on the sidelines for spreads to widen could therefore miss out on potential credit carry (the accrual of credit spread over time.) Even at the current tight credit spreads, if you spend a year invested in gilts rather than credit you could potentially miss out on about 1% from carry.

**iBoxx £ non-gilts – days below 25th percentile**

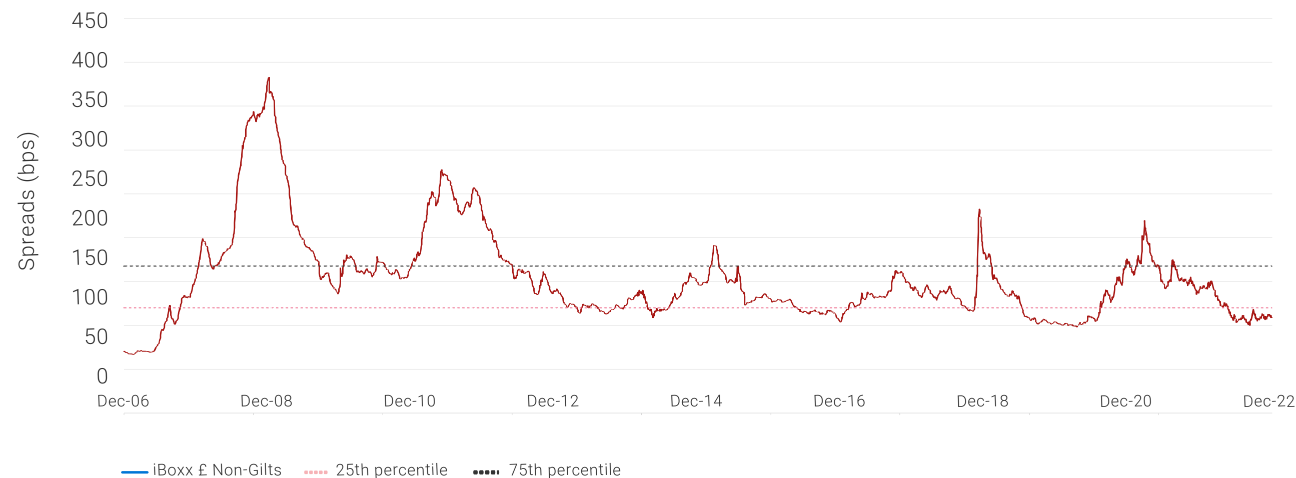
| Start date | End date | Days |
|---|---|---|
| 26/01/2024 | 30/09/2024 | 248 |
| 18/11/2020 | 03/02/2022 | 442 |
| 08/01/2020 | 24/02/2020 | 47 |
| 30/05/2017 | 14/03/2018 | 288 |
| 06/02/2015 | 03/06/2015 | 117 |
| 30/04/2014 | 05/08/2014 | 97 |
| 02/01/2014 | 29/01/2014 | 27 |
| 19/09/2007 | 12/11/2007 | 54 |
| 31/12/2006 | 11/09/2007 | 254 |
| **Average** | | 175 |

Source: LGIM, S&P Global, Markit as at 30 September 2024. iBoxx non-Gilts percentiles from 31 December 2006 to 30 September 2024.
**Past performance is not a guide to the future.**

Our research[5] (which includes theoretical back tests) indicates it's much more challenging to generate better risk-adjusted returns than a static strategy by using only a spread signal i.e. increasing credit exposure when spreads widen.

Why is it difficult? One observation is that if it were easy everyone would be doing it already. However, a perhaps more insightful observation is to note changes in risk. In stressed markets, expected (excess) returns go up but normally so does risk[6].

**Credit spreads are low in a historical context**




Source: LGIM, S&P Global, Markit as at 30 September 2024. iBoxx non-Gilts percentiles from 31 December 2006 to 30 September 2024.
**Past performance is not a guide to the future.**

## Practical implications for investors

**Focus on downgrades and defaults:** Cashflow-matching credit investors like pension schemes and insurers can look through mark-to-market fluctuations and only concern themselves with downgrades and defaults. If these are sufficiently modest then changes in risk may be less of a concern and the priority may be to target higher expected returns. In this case we believe it may make sense to play a 'weighting game', i.e. delaying investing in credit now in the hope of more attractive opportunities in the future, particularly over longer horizons. Watch this space for more on this research.

**Invest in shorter-dated credit:** Although it incurs reinvestment risk, shorter-dated credit could potentially be beneficial for those seeking a yield pick-up relative to gilts but are concerned about a reversion to the mean. This is because shorter-dated credit is typically less sensitive to spread widening[7]. Other strategies to consider now could involve a focus on higher-quality credit or diversifying across other fixed income markets such as securitised credit, corporate hybrids, or investment-grade emerging market debt.

**Risk match:** Investors may have exposure to credit spreads that they seek to risk match. For example, DB schemes considering buyouts or buy-ins in the near term may wish to align their strategy to reflect what insurers are doing.

**Consider wider circumstances:** The weighting decision isn't just a function of market conditions – it is also a function of an investors' position and objectives. DB schemes that are better funded or have a shorter time horizon (so have less time to wait for spreads to widen) may be more willing to allocate to credit, despite low spreads.

3. Another reason is that insurers often vary their credit exposure with spreads. This means there can be significant credit sensitivity of prices even if their credit allocation to credit is low because price movements are driven not only driven by the current pricing portfolio but also how the portfolio will change if market conditions change. 4. For a discussion of how we estimate sensitivities under normal market conditions please read The endgame is nigh: time to pay more attention to credit? 5. To read more about this research, please read LGIM Blog: Investing for the endgame at low spreads 6. To discover more about this, please read Mind the risk: The value of valuations. 7. In addition, our research indicates that short-dated credit can be a surprisingly powerful diversifier of cashflow-matching credit: Cashflow-matching credit – room for improvement?

# Illiquidity innovation

## What solutions are available to schemes for their illiquid asset exposure as they approach a buy-in or buyout transaction?

The PRT market displayed notable resilience last year, with transaction volumes likely to have exceeded £40bn in 2024, according to our estimates. With PRT likely to remain one of the popular endgame options, there is increasing awareness of the potential challenges posed by holding illiquid assets when transacting a buy-in or buyout. Thankfully, the market is evolving at pace to help schemes address these challenges.

### What do insurance companies look for?

Insurance companies might be motivated to hold illiquid assets if they can provide predictable cashflows with relatively low levels of risk (consistent with an investment grade credit rating) and subject to insurance regulation. Additionally, these assets need to be held directly by the scheme (or in a 'fund-of-one').

An example could be a directly held portfolio of investment grade corporate bonds. If the assets are held within a pooled fund, whether that's an open-ended or a closed-ended fund, then an insurance company cannot typically use it within its annuity-matching portfolios, leading to significant cost implications.

If either of these conditions are not met, i.e. assets do not provide predictable cashflows (e.g. private equity) or they are held in pooled funds, then the transfer of these assets to an insurer in-specie is not straightforward and might lead to both timing and cost issues.

### A question of time

Schemes can choose to tackle this challenge either in the years ahead of a buy-in/buyout transaction or at the point of a transaction, with advantages and disadvantages of each approach.

By allowing a number of years to wind down an illiquid asset portfolio, schemes may be able to optimise opportunities to redeem units from open-ended funds, wait for a closed-ended fund to wind down or sell assets in the secondary market, all of which may help to preserve value.

However, if a buy-in / buyout is almost within reach and illiquid assets are the main hurdle, then there are options available when working with an insurer on a transaction

### Solutions for illiquid assets

First, the insurer may be able to offer a partial deferred premium such that a scheme can take some time to find solutions for the illiquid assets subsequent to getting a deal agreed. The scheme can then work in partnership with an investment manager and the insurer to find those solutions after a buy-in is agreed.

Investment managers working under an investment mandate can offer what is effectively a 'private market transitions service', borrowing concepts from helping clients with public market transitions where decisions to trade are made under a rigorous framework aimed at preserving value. Choosing whether to accept or reject bids can have financially very material consequences and investment managers may be best-placed to make these investment decisions.

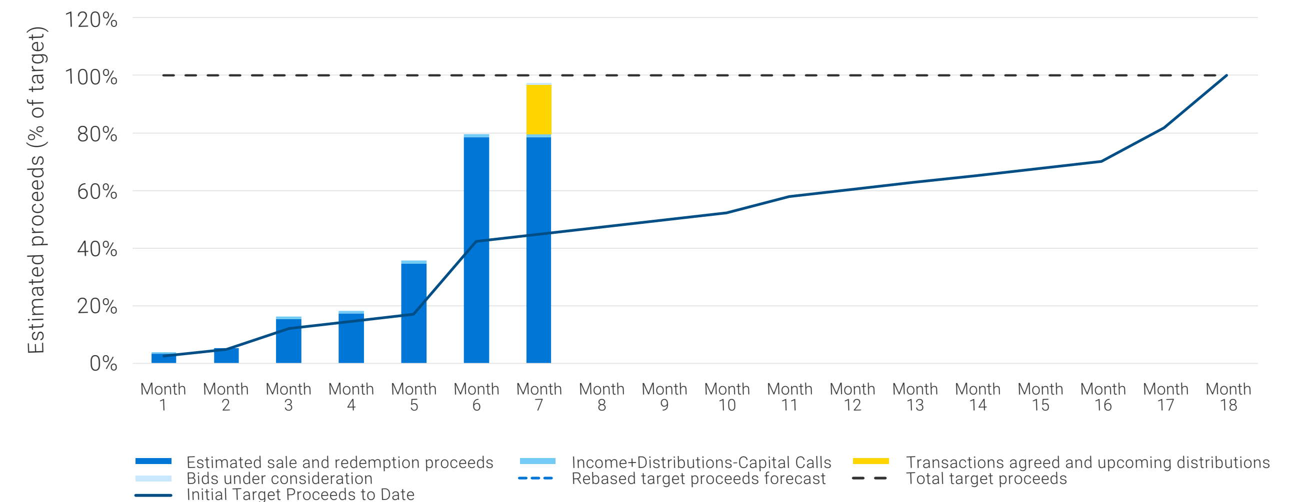
We believe this type of service could help schemes either in the years ahead of a potential transaction or in the context of an actual transaction. An example of a chart displaying progress winding down a portfolio against a benchmark agreed with a client is shown below. It has been derived from a version used in a real-life mandate where the investment objective was explicitly to sell funds holding illiquid assets over an extended, but defined, time period.

| | | Asset holding basis | |
|---|---|---|---|
| | | **Directly held or fund-of-one** | **Pooled fund** |
| **Predictability of cashflows** | Predictable cashflows | Predictable cashflows, directly held | Predictable cashflows, pooled fund |
| | Unpredictable cashflows | Unpredictable cashflows, directly held | Unpredictable cashflows, pooled fund |





**Estimated total proceeds to date and estimated target proceeds forecast**




Source: L&G, as at November 2024. **Assumptions, opinions, and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.**

Outside of these routes, other potential options are currently being explored within the market, including securitisation of fund interests, which may allow insurers to hold pooled funds more easily. Similarly, platforms are currently setting up to help trade illiquid fund interests more transparently which could lower transaction costs over time, potentially increasing future buy-in / buyout affordability.

**Aniket Das**
Head of Multi-Manager Solutions

**Mathew Webb**
Head of Endgame Solutions

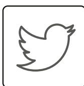
With this evolving backdrop in mind, we have three key messages for schemes:

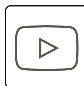
1. If your immediate priority is buyout, then insurers have a range of solutions to ensure that illiquid assets need not be a barrier to transacting.
2. If you have more time, then a plan of action built in partnership with an investment manager can help you to restructure asset holdings to improve your scheme's readiness for buyout down the line.
3. The real 'illiquidity innovation' here can be realised by combining approaches 1) and 2). In other words, you can ask your asset manager to help get your pension scheme ready while simultaneously giving your insurer a target to exchange the scheme's portfolio of assets to enable the transaction to take place.

As schemes look ahead in 2025, we believe those holding illiquid asset exposure and also considering buyout may do well to heed the example shown in the chart above. As the saying goes, what gets measured gets managed. So consider analysing your illiquid asset options, setting a target on that basis and then measuring success against that target.

# Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative





**Key risks**

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and the investor may get back less than the original amount invested.

**Important information**

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